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## **When Will Economics Guide IMF and World Bank Reforms?**

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The Meltzer Commission Report (a blueprint for reforming the IMF, the World Bank, and other multilateral development banks released in March, and signed by a bipartisan majority of 8 to 3) has generated its share of criticism from opponents in the Commission minority, the Administration, the labor unions, and the Congress.<sup>1</sup>

Since our Report was published, it has become clear to me that two separate debates are being waged over the new “financial architecture” – a narrow (visible) debate over the technical aspects of specific proposals for designing mechanisms to achieve well-defined economic objectives, and a broader (less visible) debate over whether the IMF, the World Bank, and the other development banks should have narrowly defined economic objectives or alternatively, be used as tools of ad hoc diplomacy. Until we settle that second, broader political debate, we cannot seriously even begin the constructive dialogue over how best to achieve economic objectives. That dialogue is important; our proposals are a starting point for rebuilding these institutions, not the final word. But those who oppose the basic premises of the Meltzer Report don’t want to get to that constructive phase. They want the reformers to just go away. Although open opposition to the Meltzer Report generally focuses on its details, behind closed doors critics are candid about their primary reason for objecting to our proposals: “Forget economics; it’s the foreign policy, stupid.” For proposed reforms to succeed, then, they must face the challenges posed not only by economic logic, but by the political economy of foreign policy.

In this article, I summarize the recommendations of the Commission and respond to criticisms of our recommendations, both from the standpoint of their economic logic and their political economy. I argue not only that the Commission’s recommendations make sense as economics, but defend the principles on which they are based, specifically,

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<sup>1</sup> The Commission members who signed the Report include Allan Meltzer (Chairman), Tom Campbell, Edwin Feulner, Lee Hoskins, Richard Huber, Manuel Johnson, Jeffrey Sachs, and the author of this article. Fred Bergsten, Jerome Levinson, and Esteban Torres did not sign the Report. Mr. Huber, despite signing the Report, dissented on some points. The Report, Commission hearings, and background papers for the Commission (known formally as the International Financial Institution Advisory Commission) are available at the website <http://phantom-x.gsia.cmu.edu/IFIAC>

the premise that the World Bank and the IMF should not and cannot continue to serve the ad hoc political purposes of broad foreign policy.

### *First Principles*

The Meltzer Report begins with a well-defined set of economic objectives and political principles, and suggests mechanisms that would accomplish those objectives within the confines of those principles. The economic objectives we envision for the multilateral financial institutions include: (1) improving global capital market liquidity, (2) alleviating poverty in the poorest countries, (3) promoting effective institutional reforms in the legal and financial systems of developing countries that spur development, (4) providing effective global public goods, e.g., through programs to deal with global problems of public health (particularly, malaria and AIDS), and environmental risks in developing countries, and (5) collecting and disseminating valuable economic data in a uniform and timely manner. The Commission viewed liquidity provision during crises, macroeconomic advisory services, and data collection and dissemination to be appropriate missions of the IMF, and saw poverty alleviation, the promotion of reform, the provision of global public goods, microeconomic data collection and dissemination, and related advisory services as the central missions of the development banks.

We identified six principles that any credible reform strategy should satisfy, and which underlie our proposals: (1) respecting member countries' sovereignty (that is, the desire to minimize the intrusiveness of membership requirements or conditions for receiving assistance), (2) clearly separating tasks across institutions (to avoid waste and counterproductive overlap, and to enhance accountability), (3) setting credible boundaries on goals and discretionary actions (to prevent undesirable mission creep and to promote accountability), (4) judging policies not by their stated objectives but by their effectiveness (i.e. ensuring that the mechanisms chosen to channel assistance are likely to succeed and to avoid waste), (5) ensuring accountability of management through clear disclosure, accounting, internal governance rules, and independent evaluation of performance, and (6) sharing the financial burden of aid fairly among benefactor countries.

### *The Record of IMF and Development Banks Performance*

We began by evaluating the performance of the IMF, the World Bank, and the other development banks against the touchstone of these goals and principles and found these institutions quite deficient. They often failed to achieve their goals, even by their own internal measures. Studies of the extent to which the IMF succeeds in enforcing its lending conditions show a poor track record. Sebastian Edwards found that most of the time IMF lending conditions are not met.<sup>2</sup> And all three comprehensive studies of the average effects of IMF programs, which include the IMF staff's own study, failed to find evidence of a positive effect on economic activity or domestic securities prices from having received IMF assistance.<sup>3</sup>

Why is the IMF so ineffective? For one thing, the IMF's crisis lending mechanism is not designed to fulfill the role of providing effective liquidity assistance. Liquidity crises happen quickly. There isn't time to enter into protracted negotiations, or to demonstrate that one is an innocent victim of external shocks (as the IMF's stillborn contingent credit facility mandates). If the IMF is to focus on liquidity assistance, and if liquidity assistance is to be effective, there is no viable alternative to having countries pre-qualify for lines of credit. The testimony before our Commission of the IMF's acting managing director, Mr. Fischer, recognized the desirability of prequalification for providing liquidity assistance.<sup>4</sup> The current IMF formula of taking weeks or months to negotiate terms and conditions for liquidity assistance, and then offering that assistance in stages over a long period of time, simply is a non-starter if the goal is to mitigate or prevent liquidity crises.

IMF and development bank lending – which entails substantial subsidies to borrowing countries – does, however, manage to transfer resources to debtor countries during severe economic crises. But those transfers do not seem to improve securities markets or spur growth; rather, they are put to use for less laudable goals – most

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<sup>2</sup> "The International Monetary Fund and the Developing Countries: A Critical Evaluation," *Carnegie-Rochester Series on Public Policy*, 31, 1989, pp. 7-68.

<sup>3</sup> R.A. Brealey and E. Kaplanis, "The Impact of IMF Assistance on Asset Values," Working Paper, Bank of England, September 1999, N. Ul Haque and M.S. Khan, "Do IMF Supported Programs Work? A Survey of Cross Country Empirical Evidence," IMF Working Paper, November 1999, M.D. Bordo and A.J. Schwartz, "Measuring Real Economic Effects of Bailouts: Historical Perspectives on How Countries in Financial Distress Have Fared With and Without Bailouts," Working Paper, Rutgers University, November 1999.

notoriously, for shady transactions in Russia or the Ukraine. But it's the "legitimate" uses of IMF and development bank emergency loan subsidies that are even more troubling, especially their use in facilitating the bailouts of insolvent domestic banks and firms and international lenders, which ultimately are financed mainly by taxes on domestic residents.

In the cases of Mexico, Korea, Indonesia, and Thailand, those tax bills ranged from 20% to 55% of annual GDP, and averaged more than 30% of GDP. Not only do these bailouts transfer enormous wealth from average citizens to rich cronies, they undermine market discipline (by softening the penalties for unwise investing) and encourage reckless lending domestically and internationally. They also strengthen the hold that domestic cronies continue to exert on their countries' political systems.

Consider the current IMF program being established with Ecuador. Ecuador has been suffering a deepening fiscal crisis for several years caused by the combination of an unresolved internal political struggle, adverse economic shocks to its terms of trade, and a poorly regulated banking system (which encouraged enormous risk taking at taxpayers expense, and which has imposed a bailout cost of 40% of annual GDP on taxpayers). As yet, there is no consensus for reform in Ecuador, and there is no reason to believe that reforms will be produced by a few hundreds of millions of IMF dollars. Why in the world is the IMF sending money to Ecuador? Some observers claim that IMF aid to Ecuador is best understood as a means of sending political payola to the Ecuadoran government at a time when the United States wishes to ensure continuing use of its military bases there monitoring drug traffic. Will that sort of IMF policy be likely to produce the needed long-run reforms in fiscal and bank regulatory policy? Hasn't the IMF learned anything from the failure of its lending to Russia in 1997-1998?

Argentina, perhaps more than any other country, has depended on IMF conditional lending over the past several years to maintain its access to international markets. It is now widely perceived as possibly on the verge of a public finance meltdown, which many commentators blame, in part, on the IMF and U.S. Treasury. IMF support, in retrospect, was counterproductive because it put the cart of cash ahead of the horse of reform. Now Argentina is faced with a growing, and possibly an

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<sup>4</sup> See the testimony of Stanley Fischer before the Commission on February 2, 2000.

unsustainable, debt service burden. Furthermore, at the IMF's behest, Argentina substantially raised its tax rates last year, choking off its nascent recovery. Instead, Argentina should have cut government expenditures. The notion that tax hikes are an effective substitute for expenditure cuts as a means of successful fiscal reform is an article of faith at the IMF, but unfortunately, one that is at odds with the evidence. The chronology of policy failure in Argentina is aptly summarized in a recent financial markets newsletter:

“Between 1996 and 1999, the IMF and IDB all but led the marketing effort for Argentina bonds. The two institutions voiced strong endorsements each time that there was a confidence crisis in Argentina. The IDB went so far as to dispatch its most senior economist to New York last summer to recommend that U.S. portfolio managers buy Argentine bonds. At the same time, the Street came to realize that the U.S. Treasury was the real force behind the IMF and IDB support for Argentina. It was never clear why there was such unwavering support. The motivation could have been geo-political. Argentina was a staunch supporter of U.S. political policies around the world and across the region. Argentina was also the poster-child of the so-called Washington Consensus. ...Therefore, the U.S. needed Argentina to succeed. At the beginning of the year, when the Machinea team traveled to Washington to seek a revised Standby Facility, the team met first with the U.S. Treasury before meeting with the IMF and the World Bank. These actions sent clear signals to the market that the country had an implicit guarantee from Washington. Otherwise, it would have been irrational for any creditor to lend so much money to such a leveraged country with such little flexibility.”<sup>5</sup>

How Argentina will extricate itself from its current debt trap is unclear. What is clear, however, is that the U.S. Treasury/IMF-sponsored debt inflows and tax hikes of the past several years put Argentina into this risky position. More market discipline, less U.S. Treasury/IMF “assistance,” and less debt, at an earlier date would have encouraged the needed reforms of government expenditures and labor market regulations.

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<sup>5</sup> BCP's Molano Latin American Daily, May 15, 2000.

The World Bank's record, and the records of the regional development banks, in sponsoring successful programs are also poor. The World Bank's internal evaluations of performance (which are made shortly after the last disbursement of funds) identify more than half of its projects as failing to achieve "satisfactory, sustainable" results. The World Bank earmarks subsidized loans to member countries, but does little to ensure that the funds are used for the stated purposes. And the allocation of funds is primarily to countries with easy access to private capital markets. Over the past decade, the World Bank has lent 70% of its funds to 11 countries. These countries are not among the poorest or those lacking access to markets. Indeed, for those countries, development bank loans average less than two percent of total capital inflows during that period.

The Commission found that development banks were ineffective as promoters of reform. As shown in the work of David Dollar and others at the World Bank, programs that subsidize institution building only work in countries that already have a commitment to reform.<sup>6</sup> Reform-minded governments offer windows of opportunity for change, and under those circumstances constructive reforms can be hastened and broadened by appropriate external assistance, which can benefit not only the recipient but other countries as well (including the United States). But to be effective, subsidies have to reward bona fide efforts, not just lip service. There is a need to improve dramatically the way reform subsidization is delivered to ensure that it is channeled effectively where it can have the greatest positive impact.

The Meltzer Commission also found that the development banks are devoting far too little to alleviating global problems in the areas of public health, particularly the endemic problems of AIDS and malaria, which are important stumbling blocks to economic development in many of the poorest countries.

None of the international financial institutions clearly defines and limits its spheres of activity. The IMF's mission warrants short-term lending, yet the IMF typically makes long-term loans. Sixty-nine countries have borrowed from the IMF for a total of more than 20 years, and 24 of those countries have borrowed for more than 30 years. Seventy-three countries have borrowed from the IMF in more than 90% of the

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<sup>6</sup> *Assessing Aid*, Oxford University Press for the World Bank, 1998.

years they have been members of the IMF.<sup>7</sup> The development banks participate in short-term emergency lending, despite the fact that this is not consistent with their long-term focus on development, and even though their managements sometimes privately complain about having to do so.

There is little disclosure of relevant information about accounting or decision making. In the case of the IMF, its own staff admits that its accounting system is an exercise in obfuscation:

“The cumulative weight of the Fund’s jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for which the balance sheet...contains no information whatever on the magnitudes of its outstanding credits or its liquid liabilities. More seriously, the Fund’s outdated financial structure has been a handicap in its financial operations.”<sup>8</sup>

With regard to the principle of respecting sovereignty, critics of all political persuasions seem to agree that the international institutions should reduce their intrusiveness. Labor union officials complain that conditions for assistance requiring labor market “flexibility” undermine the position of trade unions. Martin Feldstein has faulted the IMF for undermining debtor countries sovereignty through excessive micromanagement of the conditions attached to subsidized loans.<sup>9</sup> George Schultz and others complain that the sovereignty and constitutional frameworks of creditor members are also undermined, since loan subsidies often serve as an end-around the legislative oversight that should accompany foreign aid.

### Proposals for Reform

The Meltzer Commission’s recommendations for reform follow directly from the perceived gap between actual performance of these institutions and the combination of bona fide objectives and principles that we viewed as non-controversial. With respect to

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<sup>7</sup> Ian Vasquez, “The International Monetary Fund: Challenges and Contradictions,” Cato Institute, 1999.

<sup>8</sup> Jacques Polak, “Streamlining the Financial Structure of the International Monetary Fund” (Princeton: Essays in International Finance 216, September 1999), p. 2.

<sup>9</sup> “Refocusing the IMF,” *Foreign Affairs*, March/April 1998, pp. 20-33.



the IMF, the Commission *unanimously* voted to end long-term lending. The 8-3 majority went further, recommending that the IMF focus on maintaining liquidity for emerging economies. By providing lines of credit to countries that meet minimal pre-established standards, and lending to them as a senior creditor at a penalty rate, the IMF could prevent avoidable liquidity crises without sponsoring counterproductive bailouts of banks at taxpayers' expense.

The terms under which the IMF would lend are crucial to our reform proposal. Under current practice the IMF lends at a markup over its cost of funds. That is not a penalty rate – for many countries it implies a substantial subsidy. Our proposed penalty rate removes that subsidy. Countries facing a bona fide liquidity crisis (including those with past fiscal problems that have decided to improve their fiscal discipline) would benefit by borrowing short-term at a penalty rate, since such borrowing would allow them to avoid unnecessary collapse. But countries seeking financial assistance for bailouts would get no benefit from senior IMF lending at a penalty rate. Countries facing both a liquidity crisis and a banking crisis would still likely access IMF lending, but doing so would discourage fiscally costly bailouts of banks. Borrowing on senior terms from the IMF at a penalty rate would not channel subsidies to a country that chose to expand its public deficit by bailing out its banks; indeed, it would hamper that country's ability to raise and retain private funds. Thus IMF complicity in bailouts would be avoided.

The proposed pre-qualification requirements for IMF lending are few. They include meeting IMF fiscal standards and prudential banking standards (that is, requiring that banks maintain adequate capital and liquid reserves). IMF discretion would be relied upon in setting and enforcing prequalification standards. Those standards reduce the likelihood that borrowing countries would access IMF lending to sponsor bailouts at their taxpayers' expense. We also recommend requiring that countries with access to IMF credit be required to permit free entry into their financial systems by foreign financial institutions. That requirement would go a long way toward ensuring competitive, stable banking in emerging markets, and in so doing would substantially reduce the likelihood and magnitude of bank bailouts. More than 50 countries already have agreed to this WTO provision. Over the five years that we envision for the transition to this new pre-

qualification system virtually all emerging market countries would be able to meet these standards.

Our pre-qualification requirements are designed to avoid, rather than increase, intrusion by the IMF into the sovereignty of borrowing countries. IMF conditionality now is ex post, customized micromanagement (which is necessarily very intrusive). We suggest, instead, making IMF liquidity assistance available based on clearly specified rules which are the same for all countries. The requirement that countries allow free entry into financial services is not designed to force countries into greater free trade, per se, but to protect borrowing countries' citizens from bearing the costs of IMF-sponsored bailouts. The IMF's complicity in the bank bailouts in Mexico, Asia, and elsewhere – which the pre-qualification standards and penalty rate would avoid – has been a far more important invasion of sovereignty than our pre-qualification standards would be.

What would happen if the stability of the global financial system were at stake because a large developing country in need of liquidity assistance had not pre-qualified? The report recognizes that the pre-qualification requirement could be waived in such a circumstance, but the lending limits, the IMF's senior status, the short maturity, and the penalty rate would still apply.

With respect to the development banks, for poverty alleviation, we recommended relying on grants to service providers with independent verification of performance, rather than loans earmarked to governments, as a mechanism more likely to deliver results. Development banks would share the burden of financing projects with recipient governments. For the poorest countries, the development banks would pay nearly all cost, but for those with higher per capita income the share of development bank support could be much lower. Grants would be paid to service providers, not governments, and those providers would compete for projects in open auctions. No grants would be paid out by development banks unless independent auditors had verified that the providers had actually achieved the stated objectives.

With respect to promoting institutional reform, the Commission proposed making loans to governments at highly subsidized rates, but only *after* they had passed laws establishing reforms. The maturity of those loans would be extended (and thus the subsidies increased) conditional on the continuation of reforms – that is, only if

independent verification indicates that promised reforms are continuing on track. For example, if a country passed a bankruptcy reform law, it would be eligible for a subsidized loan in support of implementing that new law (which can be a protracted and difficult process). Continuing progress after the law was passed (as indicated, for example, by an independent international group that rates the performance of countries' bankruptcy systems) would be a prerequisite to extending the duration of the loan.

We recommend focusing country-level poverty assistance and reform subsidies on the poorest countries, where it is needed most (a distinct departure from current practice). And we suggest devolving much of the authority over country-specific programs that combat poverty or support institutional reforms to regional development banks, leaving the World Bank to pursue neglected global public goods provision, for example, in the areas of health and the environment.

Are the existing resources of the international financial institutions adequate to meet these objectives? Yes and no. If the IMF refocused its efforts on emergency liquidity assistance, offered at a penalty rate, it could provide substantial benefits at little cost. So the IMF's capital is more than adequate. The resources currently available to the development banks could provide substantially greater and more effective assistance if the Commission's recommendations were adopted. However, the Meltzer Commission recommended substantial new appropriations for these institutions, if they can be reformed to improve their effectiveness.

The Commission also voted *unanimously* that the IMF and the development banks should write off all claims against the highly indebted poor countries (HIPC) once those countries have established credible development programs. The financial distress of the HIPC is as much an indictment of multilateral lenders (and the governments that control them) as it is of the leaders in the borrowing countries who often wasted those funds or used them for personal gain, leaving their impoverished citizens with an enormous debt burden. If the multilateral lenders can reform their policies so as not to produce these debt burdens again in the future, and if the HIPC can establish the basic foundations for growth, there is little point to continuing to punish the citizens in these countries for the mistakes of the policy makers of the past. However, without substantial reforms of the international financial institutions, debt relief will accomplish little in the long run;

without reform, debt forgiveness would be a prelude to rebuilding the mountain of unpayable debt that now faces HIPC countries.

### Reactions To the Report

The editorial pages of the New York Times, the Wall Street Journal, and the Financial Times have been favorably disposed to some or all of our recommendations, which has helped us to get a fair hearing. Some G7 officials outside the United States (notably officials in Germany, the U.K., Canada, and the ECB) have expressed strong support for the thrust of our recommendations on IMF reform. The IMF, the U.S. Treasury, and the World Bank have each agreed with some of our criticisms and recommendations, and some of the reforms they are currently implementing move slightly in the directions we suggest (or at least appear to do so). Specifically, the IMF claims that it will improve its contingent credit line facility to attract more countries to sign on to it, and the Treasury Secretary has called for a scaling down of long-term IMF lending (although neither the IMF nor the Treasury has accepted the need to focus the IMF primarily or exclusively on liquidity assistance, as opposed to emergency aid broadly defined). While the World Bank has rejected our grant-based approach for providing assistance, and our call for HIPC debt forgiveness, in at least one recent case they seem to have accepted the essence of our argument for grant-based support. In late April, when considering the funding of the “Economic Recovery Project” to Burundi, the

"Donors are concerned that any budget support, without appropriate controls, might be misused for military purposes ....It is for this reason that this ERC differs from normal Bank quick disbursing operations. Foreign exchange will be provided to the private sector, its distribution and value determined through auction."

Despite these small, encouraging signs, and the enthusiastic support the Report has gotten from some members of Congress and some policy makers outside the United States, the thrust of the reaction to the Report from the Treasury Department, the World Bank, the IMF, and some other members of Congress has been negative. Richard Gephardt referred to the Report as “isolationist.” Pete Stark (who admitted publicly that he had not read the Report) nevertheless characterized our proposals as “laughable.”

Treasury Secretary Lawrence Summers, testifying before the House Banking Committee (while reserving the right to change his mind based on further reading of the Report) faulted the Commission on several specifics. Given the influence that Mr. Summers' views may exert on the reform movement, it is worth addressing his criticisms in detail.<sup>10</sup>

At the hearings, Mr. Summers expressed concern that forgiving too much of the HIPC debt might hurt the HIPC countries themselves by making it harder for them to access capital markets in the future. It is important to stress that our report only spoke to the question of forgiving the debts owed to the multilaterals. In my view, it would not be necessary or constructive for the HIPC countries to default on, or seek forgiveness of, their private sector debt. So long as debt forgiveness is confined to the debts of the multilaterals, and the debts held by individual sovereign creditors, I see no reason why the HIPC countries would be penalized by the private capital markets. Furthermore, the historical literature on debt default indicates that "warranted" sovereign debt write downs (those which are practically unavoidable because of the high cost of debt service relative to available income) are not penalized very much by future creditors. Because the HIPC countries clearly fall into the category of warranted debt forgiveness, I think the Secretary's concerns about the costs they would bear from debt forgiveness are misplaced.

With respect to our proposals for reforming the IMF, Mr. Summers expressed several concerns. He claims that "few if any of the countries that have suffered financial crises in recent years...would have qualified for emergency IMF support." He goes on to recognize that the Commission recommended waiving prequalification standards in cases where global capital market stability was threatened, and that therefore, the Commission did not, in fact, recommend ruling out support to any country. Still the Secretary questioned, in light of our recommendation that prequalification could be waived, "how the rest of the Report's proposals in this area are to be interpreted and applied." He questioned whether many countries would prequalify for IMF support, and whether lending even to prequalified countries would create moral hazard problems (in comparison to the current practice of attaching "conditionality").

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<sup>10</sup> All references to statements by Secretary Summers are from his testimony before the House Banking Committee on March 23, 2000.

The Secretary's concerns again are misplaced. First, we envision a phase-in period of five years for the new prequalification standards, and we think most emerging market countries would prequalify. Most or all of the crisis countries in Latin America and Asia would face strong incentives to meet our proposed standards, particularly since failing to do so would likely reduce their access to, and raise their costs of, private finance. If our proposed standards had been imposed, say, in 1990, the severe crises suffered by these countries (which largely reflected weaknesses in their banking systems and the incentives of those weak banks to take on enormous exchange rate risks) may have been averted, and certainly would have been far less severe.

Furthermore, it is hard to see how our proposed IMF lending arrangements would worsen moral hazard. Moral hazard depends on the expectation of receiving a subsidy. Under current IMF arrangements, countries borrow large amounts at highly subsidized rates. The conditionality imposed on these countries (particularly in the area of financial sector reform) is not enforced and not effective, owing in part to the short disbursement time period of emergency lending and the long time period required for meaningful reform. Under our proposals, there is no subsidy, and therefore, virtually no moral hazard. Prequalifying countries would be able to borrow a limited amount on a short-term basis in the form of senior debt at a penalty rate; those that receive emergency assistance without having prequalified must borrow at a super-penalty rate, which provides further assurance that no subsidies would flow to those borrowers.

Another concern expressed by Mr. Summers is that the Commission's report presumes "that crises emerge almost exclusively from flaws in the financial sector." This is a significant misunderstanding of our report. According to our proposals, the role of the IMF would be to protect against liquidity problems in the markets for foreign exchange and sovereign debt that come from problems *other than* banking sector fragility. The point of the prequalification standards is to prevent the IMF from being misused as a mechanism for facilitating financial sector bailouts. Its main function lies elsewhere – specifically in providing protection against market illiquidity, either due to information problems that result in the temporary collapse of markets, or problems of self-fulfilling speculative attacks.

The Secretary criticizes our proposals for failing to provide IMF support to deal with “balance of payments problems.” I am not sure what the Secretary means by a “balance of payments problem.” Our proposals for IMF lending are designed to counter balance of payments outflows resulting from bona fide liquidity crises. Our proposals would not channel counter-cyclical subsidies to countries that suffer balance of payments outflows, per se. In our view it would be inappropriate to charge the IMF with the broad mandate of providing global counter-cyclical fiscal subsidies to its members.

Mr. Summers also criticizes our recommendations for reforming the development banks. He objects (1) to limiting emergency lending to the IMF, (2) to our proposal to target country-level assistance to the poorest countries, and (3) to the use of grants rather than loans for poverty alleviation.

Our proposal to limit emergency lending to the IMF follows directly from the principle that separating the functions of the various multilaterals promotes greater effectiveness and accountability. Under our proposals the IMF would have the capacity to deal with all bona fide liquidity problems that would arise. There is no need for the other multilaterals to assist it in providing short-term assistance.

Nevertheless, the Commission Report envisions loans or grants from development banks to poor countries that have experienced crisis-induced trauma. We recommend that any assistance to alleviate poverty or to spur reforms should be channeled through appropriate long-term programs, and that in the case of reform programs, these should be designed to ensure that the flow of aid is credibly linked to the implementation of reforms undertaken by recipients.

The Secretary also misunderstands the effect of our proposals on poor people who reside in developing countries with access to private capital markets or with per capita annual average incomes higher than \$4,000. He states that “the Report would rule out MDB support for the majority of the world’s poorest people.” That is not true. While we recommend that the MDBs focus their *country-level* poverty alleviation funding on the very poorest countries that lack access to private capital markets, we would have the World Bank *expand* its support to the poor *throughout the world* through two channels: financial assistance for supplying *global public goods*, particularly in the areas of public health and the environment, and technical assistance to all developing countries.

Similarly, the Secretary's statement that "the Report's recommendations would drastically undercut the global role of the World Bank by limiting it to the 'knowledge' business" indicates a serious misunderstanding of our recommendations. We envision a substantial continuing role for the World Bank in providing financial assistance.

Finally, Mr. Summers' statement that "the shift to grant-based funding would drastically reduce the total amount of official resources that can be brought to bear in these economies" confuses the dollar amount of *lending* that the development banks currently provide with the dollar amount of *assistance* implicit in that lending (the amount of interest subsidy). So long as the development banks retain their capital (as we recommend), under our proposals they will be able to channel *more* assistance using grants than using loan subsidies, and crowd in a *greater* flow of credit, to the world's poorest countries than they do today. That is so even before taking into account our recommended increases in funding for the development banks. Current World Bank loans transfer money to borrowing countries in advance and require borrowing countries to guarantee repayment. Grant funding frees up additional resources by allowing countries to use their limited potential to guarantee repayment to support private market borrowing to finance their share of project costs. Also, unlike grant subsidies, the amount of subsidy transferred through a loan is limited by the fact that loans can't bear an interest rate less than zero. Taking these advantages of grant-based assistance into account, Adam Lerrick of the Commission staff estimated that a grant-based program would support a volume of development projects for poverty alleviation and institutional reform 80% larger than that of the current loan-based programs.

I do not mean to suggest that there is no room for disagreement on the details of our recommendations. Indeed, it would be remarkable if that were so. Rather, in reviewing and responding to these arguments I hope to show that the reorganization of these institutions and the new policy mechanisms we suggest for them (e.g. IMF liquidity lending with prequalification, grant-based poverty alleviation, credible subsidization of long-run reforms, and HIPC debt relief) are quite reasonable and practical economic mechanisms.



*“Forget Economics: It’s the Foreign Policy, Stupid!”*

Dealing with these detailed concerns, however, is the easy part of responding to critics’ objections, and the less important part. Most critics of our proposals, including the Secretary, have a deeper problem with our Report. They do not agree with our goals and principles. Specifically, many critics do not share the goal of narrowing the latitude of the IMF and the World Bank. To some, the IMF and the development banks should be used as cost-effective vehicles for “leveraging” U.S. foreign policy. From that perspective, any limits on the “flexibility” of these institutions are undesirable, as is transparency in accounting, open voting, independent evaluation of performance, and other procedural reforms we suggest, since they only get in the way of flexibility. Indeed, to those who view the multilaterals this way, their principal advantage is the absence of accountability. Aid can be delivered, and the embarrassing deals that lie behind it are not easily traced. Time-consuming parliamentary appropriation debates and justification for the use of taxpayer funds can be avoided. This point of view is not often voiced openly, but it is nevertheless a crucial element in the current debate over reform.

Consider, for example, the recent negotiations between Pakistan and the IMF. A knowledgeable insider informs me that the United States government has told Pakistan that its access to IMF subsidized lending depends on its willingness to sign a nuclear non-proliferation treaty. According to this person, unless Pakistan agrees, the U.S. will block its IMF program. In this case, the U.S. foreign policy objective seems laudable, but is the IMF the right tool for achieving it?

The view that the multilaterals should serve the broadly and flexibly defined goals of U.S. foreign policy is wrong for at least five reasons. First, the flexibility necessary to permit the multilaterals to serve as broad foreign policy devices undermines their effectiveness as economic mechanisms. When the objectives of poverty reduction and institutional reform take a back seat to ad hoc foreign policy it is no surprise that aid mainly flows to the richest and most powerful of the emerging market countries, or that the IMF and the development banks maintain so poor a track record, even by the standards of their own internal evaluations. In my view, there is no more important goal for American foreign policy than promoting stable economic development around the

world. We should design multilateral institutions that are able to meet that challenge. Saddling those institutions with broader political mandates that weaken their ability to achieve bona fide economic objectives is counterproductive, even from the perspective of foreign policy.

Second, the use of multilaterals to pursue broad foreign policy objectives forces the management of these institutions to depart from clear rules and procedures in order to accommodate ad hoc political motivations. This undermines their integrity as economic institutions, makes it hard to establish norms for the conduct of management and mechanisms to ensure their accountability, and leads to erosion of popular support for funding the important economic goals on which they should be focused. It is ironic that some of the public officials who complain loudest about the reluctance of Congress to fund international organizations have done more than their share to produce the cynicism about these organizations that makes them so unpopular. The Meltzer Commission recommends substantial increases in the budgets of effective development banks. But the popular support necessary to raise new appropriations will not be forthcoming until these institutions regain their credibility.

Third, the subversion of the process of Congressional deliberation over foreign aid appropriations is no small cost to bear, even in the interest of pursuing desirable foreign policy objectives. It is beneath us as a democracy to sanction such behavior. If Congress wishes to delegate power over a limited amount of resources to a multilateral “political emergency fund” financed by the G7 countries, then let it do so openly, establish the appropriate governance and oversight to accompany that delegation of authority, and keep the management and funding of that entity separate from the other multilateral institutions. I am not recommending that such a fund be established, but rather suggesting that if it were, it should be created by, and be made accountable to, the governments and taxpayers who authorize and finance its activities.

Fourth, it is worth considering the adverse impact that loans from multilateral lenders with non-economic objectives can have on emerging market countries. The debt burdens that plague the HIPC countries today are primarily the result of inter-governmental or multilateral loans that were politically motivated, not private or public lending made to finance credible investments.

Finally, it may not even be feasible for the United States to continue to use multilateral financial institutions as an extension of U.S. foreign policy. Progress in the global economy will make that approach to those institutions increasingly anachronistic. A decade from now the global economy will be much more polycentric. Europe and Japan are likely to enjoy a golden era of productivity growth over the next decade, as well as substantial improvements in the sophistication of their financial systems and increases in their living standards. Many emerging market countries outside of Europe – including Korea, Argentina, Brazil, and Mexico – will soon become full-fledged industrial nations, as well. Multilateral agencies focused on bona fide economic objectives, with a more decentralized administrative structure – one that relies more on regional development banks in Asia and Latin America, financed by new benefactor countries as well as the G7 – will fit the global economy of the future better than the current structure, which is rooted in and subservient to the broad goals of U.S., or G7, foreign policy. And a World Bank that can focus cooperative efforts among a growing number of benefactor countries to address global public health and environmental problems will be increasingly valuable for the same reason.

Sooner or later, global economic progress will mandate the kinds of reforms our Commission is recommending, and a number of senior members of Congress are considering. It is worth remembering that the independence of the Federal Reserve System from the Treasury Department – a precursor of sorts to the economic rationalization of IMF and World Bank policies advocated by the Meltzer Commission – that was achieved in 1951 resulted from a shift in economic power that made it impossible for the Treasury to continue to use monetary policy as a political and economic tool.

In 1935, then Treasury Secretary Morgenthau gloated that “the way the Federal Reserve Board is set up now they can suggest but have very little power to enforce their will....[The Treasury’s] power has been the Stabilization Fund plus the many other funds that I have at my disposal and this power has kept the open market committee in line and afraid of me.” Morgenthau felt no threat from the centralization of power at the Board of Governors in 1935 and the new structure of the Federal Open Market Committee because “I prophesy that...with the seven members of the Federal Reserve Board and the five

governors of the Federal Reserve Banks forming an open market committee, that one group will be fighting the other....and that therefore if the financial situation should sour the chances are that the public will blame them rather than the Treasury.”<sup>11</sup> The prospect of retaining power while escaping responsibility always appeals to government officials.

Why was Secretary Morgenthau able to control monetary policy in the 1930s, and why did that control lapse in the 1950s? In essence, Secretary Morgenthau had more funds at his disposal (with which to expand the money supply) than the Fed had on its balance sheet (with which to contract the money supply), so the Fed was simply too small to control the supply of money. By 1951, however, the size of the Fed had grown relative to the Treasury’s resources, and its independence, codified in the Treasury Fed Accord of 1951, was a forgone conclusion.

The growing strength of other industrial and emerging economies will increase the independence of the World Bank and the IMF from U.S. Treasury control in the next decade or two. In the post-World War II era the U.S. economy reigned supreme. Being an “internationalist” meant understanding the central importance of the strategic political struggle between the United States and the Soviet Union, and the need to make economic policy subservient to that struggle. But as the polycentric post-Cold War global polity and economy take hold, it will become increasingly apparent that the United States neither should, nor can, use the World Bank and the IMF as a tool of leveraged, “stealth” foreign policy.

The Meltzer Commission Report has provided a credible starting point for reforming the multilateral financial institutions, and has persuasively argued that it is high time to begin that process. Before reform can begin, before these institutions can operate as effective economic mechanisms, they must narrow their focus, regain credibility as organizations, and recapture the trust of the taxpayers that finance their operations. And before any of that can happen, the developed countries, and especially the United States, must resolve the often unspoken controversy over whether these

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<sup>11</sup> John Morton Blum, *From the Morgenthau Diaries: Years of Crisis, 1928-1938* (New York: Houghton Mifflin, 1959), p. 352.

organizations should act as foreign policy slush funds or as bona fide economic institutions. That is the first step toward real reform.